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RESEARCH ARTICLE

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Empirical Evidence of Audit Firm Size toward Audit Quality and Reputation of Public Accounting Firm

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This study is built around the argument that market competition in highly competitive era considers firm's reputation as the primary factor in company's business sustainability. The ability of the company to produce service quality is the main factor for all of professional service companies to build its reputation. This argument is used to explain how the reputation of public accounting firm is built from quality of service as the core of the business strategy which is essential to maintain public trust. This research aims to examine the impact of audit quality on reputation of public accounting firm, which includes several independent variables namely audit firm size and audit quality. Quantitative approach method was used on this study and all data were gathered from questionnaire survey. The target populations were all of Public Accounting Firm's in Indonesia. The total sample used for this study was 73 public accounting firms in which community and path analysis method was used for hypothesis testing. Results found that reputation of public accounting firm was significantly affected by audit quality and audit quality was significantly affected by audit firm size.

Keywords: Audit Firm Size, Audit Quality, Reputation

INTRODUCTION

The development of capital market in a country is related to investors' trust. The higher investors' trust is, the more developed a capital market is. One of the most influential factors of this trust is quality of information received, especially information in the financial statements. This is what gives a public accountant a crucial role in developing the national economy. This role is especially performed in capital market industry. It is because the audit report is used as a framework for parties involved in making investment decisions and market analysis.

The phenomenon related to accountants is that they are not following standards in financial statements in the capital market. Sugito (2011) and the Registration Director of BEI (Stock Exchange of Indonesia) claim that among all 432 companies, only 75%-80% of them are considered qualified to meet the standards of financial statements. One of the causes of 25% of the unstandardized financial statements is misstatements made by accountants[i].

The phenomenon in Indonesia related to audit firm size is the dominance of "*the big four*" which controls 80% of audit market in Indonesia. It is because branches which have head offices overseas expect their companies to be audited by public accountant firms affiliated to foreign companies. Such a fact is stated by Kriswanto (2011), who is in the committee board of IKAI (*Indonesian Audit Committee*). Moreover, he said that the second thing which makes audit market taken by "*the big four*" is because public accountant firms lacks human resources. Small firms generally do not have enough human resources to audit a multinational company[ii]. It is also said by Sori *et al.* (2006) that the size of a public accountant firm is considered to support audit quality because the big ones have financial resources, facilities, technology and competent employees compared to the small ones. Therefore, we need to study the influence of the size of public accountant firms towards audit quality[iii].

One of the main components for the capital market to function well is the existence of qualified external public accountants. Skinner & Sriniavasan (2011) claims that accounting literature focuses on two motives driving public accountants to produce quality; which are litigation incentive and reputation incentive. For the first motive, if a public accountant is legally responsible for audit failure, he or she has to get a good incentive to be able to produce qualified audit to avoid sues following audit failure. The second motive is that a public accountant has reputation incentive to keep the market trust in audit produced[iv].

Related to this phenomenon and its explanation, this research is aimed to identify the influence of audit firm size toward audit quality and its impact on reputation of public accountant firms for firms which have been members of Indonesian Capital Market Accountant Forum.

EXPERIMENTAL DETAILS

2.1 Audit Firm Size

Public accountant firms have tremendous responsibility and require professional conditions to fulfil due to their responsibility to the users of audit reports[v]. They have legal rights to conduct financial report audit based on the regulations. They also provide other services for their clients, such as special audit, tax services, other attestations, accounting services and management consulting. Public accountant firms which are well-known are considered to be auditors that will produce high quality audit exceeding minimum professional requirements compared to those which are not.[vi]

Lennox (1999) points out two explanations for positive relation of the size of public accountant firms and audit quality[vii]. Such explanations are reasons behind the reputation and the deep pocket of a big public accountant firm. Lennox says that a big public accountant firm has bigger incentive to audit more accurately because they have more client-specific rents which will be lost if they give inaccurate reports. In addition, the large size of the public accountant firm contributes larger resources and wealth compared to the small ones. This argument explains that the size of public accountant firms is inseparable from quality achievement.

2.2 Audit Quality

Arens *et al*. (2010) says that *'Audit quality means how well an audit detects and reports material misstatements in financial statements. The detection aspect is a reflection of auditor competence, while reporting is a reflection of ethics'*.[viii]

Samelson and Lowenjohn (2006) claim that some proxies of audit quality which have competence on the client's industry, are responsive to the client's needs, conduct due professional care, undergo field work standards and have skeptical attitude[ix]. Referring to this definition, it is concluded that audit quality is an auditor's work of evaluating, confirming, or verifying economic activities in a company, which is related to its information accuracy reported.

To assess audit quality, two approaches which are generally used to evaluate a decision are outcome oriented approach dan process oriented approach (Chrystelle, 2006). For outcome oriented process approach, Chrystelle (2006) explains that in process oriented context, audit quality can be gained from: (i) the level of auditor's obedience to the standards, (ii) auditor's specialization level in certain industries. For outcome oriented approach, Chrystelle (2006) assesses audit quality by its audit results. Observable audit results are audit reports and financial statements[x]. This study prefers process oriented approach to assess audit quality within the assumption that audit report using outcome oriented approach can only be observed to reveal going concern opinions when a company is bankrupt[xi].

2.3 Reputation of A Public Accounting Firm

Reputation is a company's most relevant, difficult to get, and easy to lose if not well-maintained asset[xii]. Gardberg and Fombrun (2002) say that companies with a good reputation have higher probability to attract more clients and market value compared to their not well-known competitors[xiii]. This condition will eventually make companies to always do good long-term financial work[xiv]. Based on these statements, reputation is a benefit earned by a company for its good work, so a reputable company will not have difficulties to attract clients.

Audit is a process to diminish inappropriate information between managers and stockholders by using a third party to legitimate financial statements. Arens *et all*. (2010) claims that audit is needed to lessen risks of being irrelevant and incompetent for information presented in financial statements. Information relevance is related to its ability to make different decisions by helping users to make predictions in the past, present and future. Information reliability is related to its ability to state everything that should be stated. One thing related to financial statements which are generally stated by a company to the users is the existence of the role of an external public accountant firm or auditor which gives its attestation service for the company's financial statements. An auditor gives his or her arguments on appropriateness of financial statements based on generally applied accounting principles[xv].

Firth and Tan (1998) claim that audit quality is often related with the size of a public accountant firm[xvi]. The same opinion is said by Hogan (1997) who explains that big public accountant firms can give better audit quality[xvii]. On the other hand, Lee (1993) argues that a small public accountant firm and its small client will bear higher probability of public accountant's opinion which is highly dependent to the amount of audit fee paid by its clien[xviii]t. Therefore, small public accountant firms will tend to be dependent in giving opinions for their clients. Furthermore, Beattie (2001) claims that audit firm size reflects audit quality[xix].

For a public accountant firm, reputation is the most important factor because when it has a good reputation, companies will be attracted to use its service, considering that its audit results will gain better trust in the society[xx].

Baotham (2009) conducted a research in public accountant firms in Thailand. The results show that there is a relation between audit quality and auditor's reputation.

Based on this literature review, this study arrives at these two hypotheses:

1. Audit firm size influences audit quality;
2. Audit quality influences the reputation of a public accounting firm.

2.4. Research Framework

The conceptual framework is developed based on extensive literature review of studies about audit quality and reputation conducted.

The Influence of Audit Firm Size to Audit Quality

Sori and Karbhari (2006) mention that big firms will give better audit quality than the small ones. It is because they have better financial resources which enable them to take advantage of technological developments, do necessary researches and recruit more experienced auditors. They also have larger and more complete information sources on clients' portfolio to effectively detect activities which will affect clients' business life sustainability. On the other hand, they have stronger motivation and effort to avoid audit failures than the small ones do[xxi].

Francis and Yu's research (2009) agrees with this by showing that bigger firms are able to produce higher audit quality because they have more collective experiences, partners to consult and higher expertise to detect material misstatements than the small ones[xxii]. On the other hand, Choi *et al.* (2010) review the influence of the audit firm size toward audit quality in USA in 2000-200[illegible]. Its result shows that it has a positive influence toward audit quality because big firms have more opportunities to share experiences, understanding and abilities among personels on both client's business development and internal control system[xxiii]. Moreover, Sirois and Simunic's research (2011) supports this by explaining that big firms have the ability to apply technological based audit which is more accurate and quicker than it is from the small ones[xxiv].

The Influence of Audit Quality to Reputation of Public Accounting Firm

Khurana and Raman (2004) claim that audit quality exists to protect the reputation[xxv]. Eisenberg and Macey (2004:266) explain that a public accountant's role is to give reliable verification on a company's financial statement. A firm reputation is a crucial factor because when an auditor loses his or her reputation then his or her audit turns useless for his or her users. Therefore, a firm is willing to do investment for building and protecting its reputation by giving quality audit service[xxvi].

Krishnamurthy *et al.* (2006) say that a firm reputation is an inseparable thing from its audit quality so a firm's efforts to produce quality audit is an indication of its building its reputation. Related to the market condition[xxvii], Gao *et al.* (2011) argue that audit quality is the main factor to determine the life sustainability of a firm. An incapable firm will risk losing its reputation[xxviii]. Based on literature review above the writers make these hypotheses below:

1. Audit firm size have influence to audit quality.
2. Audit quality have influence to reputation of public accounting firm.

RESEARCH METHOD

The purpose of this study is to test hypotheses. This study is a causal study and was conducted in Indonesia. The unit of analysis of this study was public accounting firm. This study adopts one shot study or cross sectional study which is a study conducted in which the data were collected in one take in a period of one year in the attempt to address the research problems.

Operational Variable

In operating the variables, each variable is provided with its operational definition. The variables studied in this research are described in this section.

A. Audit Firm Size

Audit Firm Size is a scale to classify the size of public accountant firms. According to Arens *et al.* (2012), indicators of audit firm size are: Number of branches owned; Existence of international affiliation; Number of auditors[xxix].

Furthermore in this research the size of public accountant firms is named by X.

B. Audit Quality

Audit quality is defined as a public accountant's capability to detect and report material misstatements of the client's financial statements[xxx]. According to Schilder (2011) quality audit can be explained into seven indicators: Skill; Experience; Ethical value; Mindset; Capability in audit methods; Effectiveness of tools used; Existence of technical support.[xxxi]

Furthermore, in this research quality audit is named by Y.

C. Reputation of A Public Accounting Firm

The definition of public accountant firm in this research is adapting Levinthal's opinion (1992) claiming that an organization's reputation is a psychological commitment of its members united into a common principle, which eventually will reflect each individual's behavior[xxxii]. This research explains reputation of public accounting firm into two indicators: Commitment to always improve competence; Commitment to obey the rules.

Furthermore, in this research the reputation of public accounting firms is named by Z.

Sample

The target population is public accountant firms which are members of Indonesian Capital Market Accountant Forum (FAPM). We chose this target because public accountant firms which have been members of FAPM are more demanded to be able to produce high quality audits for they are one of the main references for parties involved in investment decision making. The sample of this study is seventy three public accounting firms which are members of Forum of Capital Market Accountants in Indonesia.

RESULTS AND DISCUSSIONS

3.1 Hypoteses Testing

3.1.1 Audit Firm Size Influences Audit Quality

The analysis of the data is conducted by using path analysis. The model interpretation or the testing result is interpreted in accordance with the theories of the data and logical reasoning. In order to interpret the relations between the variables, the following guidelines are used.

Table 3.1 The guidelines to interpret correlation coefficient

Coefficient Intervals	The relation level
0.000 – 0.199	Very low
0.200 – 0.399	Low
0.400 – 0.599	Medium
0.600 – 0.799	Strong
0.800 - 1.000	Very strong

Source: Sugiyono (2008)

Based on path analysis calculation, the coefficient of the path of audit firm size (X) towards audit quality (Y) is further described in a path diagram in the following Figure 3.1.

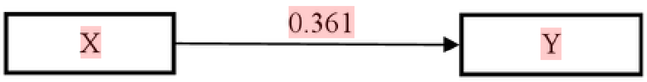

Figure 3.1. Path diagram of the influence of audit firm size (X) towards audit quality (Y)

Based on path analysis calculation, we can get coefficient value of path Audit firm size variable (X) towards audit quality variable (Y) of 0.361. Referring to Table 4.1, the relation level of these two variables is low.

The influence of variable X toward variable Y is 0.183 or 18.3%. It is shown by the value of R^2 gained from this calculation:

$R^2YX_3 \quad = \rho_{yx3} \, x \, r_{yx3}$

$= 0.361 \text{ x } 0.508 = 0.183$

Total influence of other variables not studied is 0.817 or 81.7%. Furthermore, to test the influence significance of audit firm size variable (X) toward audit quality variable (Y), T-test was conducted. The statistical hypotheses are:

H0 : $\rho_{yx} \leq 0$ Audit Firm Size does not give any positive influences to Audit Quality.

H1 : $\rho_{yx} > 0$ Audit Firm Size gives positive influences to Audit Quality.

Based on path analysis calculation, $t_{counting}$ value of the influence from variable X to Y is 4.824, but t_{table} value in α level is 0.05 with the number of samples (n) 73 is 1.995. Then, because $t_{counting}$ has higher value than t_{table} value, H_0 is rejected. This means that the size of public accountant firm gives positive influences toward audit quality. The result of this study supports the study conducted by Francis and Yu (2009) which says that big public accountant firms have more collective experience, partners to consult with and better expertise to detect material misstatements in financial statements compared to small public accountant firms. It also supports Chan and Wu's study (2011) which says that the size of a public accountant gives positive influences to audit quality.

3.1.2 Audit Quality to Reputation of Public Accounting Firm

Based on path analysis calculation, the coefficient of the path of Audit Quality (Y) toward Reputation of Public Accounting Firm (Z) is described in a path diagram in the following Figure 3.2.

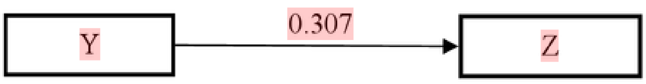

Figure 3.2. Path diagram of the influence of Audit Quality (Y) toward Public Accounting Firm (Z)

Based on path analysis calculation, the coefficient of path value of audit quality variable (Y) towards reputation of public accountant firm variable (Z) is 0.307. Referring to Table 4.1, the relation level of these two variables is low.

The influence of variable Y to variable Z is 0.156 or 15.6%. It is shown by R^2 value gained from this calculation:

$R^2ZY \quad = \rho_{zy} \, x \, r_{zy}$

$= 0.307 \text{ x } 0.508 = 0.156$

Total influence of other variables not studied is 0.844 or 84.4%. Furthermore, to test the influence significance of audit quality variable (Y) towards reputation of public accountant firm variable (Z), a T-test was run. These are the statistical hypotheses:

H0 ≤ 0 : ρ_{zy}Audit Quality does not give any positive influences to Reputation of Public Accounting Firm

H1 > 0 : ρ_{zy}Audit quality gives positive influences to Reputation of Public Accounting Firm.

Based on path analysis calculation, the $t_{counting}$ value of variable Y towards Z is 2.258, but the t_{table} in α level is 0.05 with the number of samples (n) 73 is 1.995. Furthermore, because the $t_{counting}$ value is higher than the t_{table} value, H_0 is rejected. This means that audit quality gives positive influence on reputation of public accountant firms.

These results are in accordance with Baotham's argument (2009) which says that public accountant firms which have competitive values will be able to attract more clients to use their service. It also agrees with Eisenberg and Macey's argument (2004:266) which says that audit quality can be used as a competitive quality to protect the reputation of a public accountant firm and attract more clients to use its service.

4. CONCLUSION AND SUGGESTION

4.1 Conclusion

Based on the findings and discussions, the following conclusions can be drawn:

1. The results of this study shows that audit firm size gives significantly positive influence toward audit quality. Moreover, the bigger size of a public accountant firm is, the higher is its ability to recruit competent human resources and to develop infrastructures and technology to eventually produce audit with higher quality.
2. The results of this study show that audit quality gives significantly positive influence toward the reputation of a public accountant firm. Moreover, the higher audit quality produced by a public accountant firm is, the lower possibility of the public accountant firm to suffer from consequences of audit failure is. It will eventually increase its reputation.

4.2 Suggestion

1. Concerning audit firm size, the results of this study show that its lowest indicators are indicators related to cooperation with foreign parties. The benefit of it is to strengthen internatiobal working network and the public accountant firm will also get internal monitoring (peer review) of the foreign one to keep its quality standard.
2. Regarding the reputation of a public accountant firm, the writers suggest that a public accountant firm must always encourage its public accountants to always strive for their better competence, i.e. by sending them to join seminars and professional trainings and providing updated accounting literature.

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